Annex C: Defining the market for call termination

The European Commission's conclusion that markets can be defined on an 'own network' basis is challenged by most leading economists, including advisers to the foreign regulators themselves

1. Regulators in Europe and elsewhere have chosen to define the market narrowly as being a market for the termination of calls on an individual mobile network. Having defined the market so narrowly, European regulators have moved quickly to conclude that each operator is therefore dominant within the market that it monopolizes.

2. Almost all independent commentators believe, however, that these regulators' approach to market definition and market power is wholly misconceived. This annex includes a number of papers by economic experts. The first is by Professor Jordi Gual, an economic adviser to the European Commission's Competition Directorate. He argues that regulators cannot consider market definition without reference to the overall supply conditions that mobile operators face and the services that they provide. Gual argues, as does Vodafone, that the approach adopted by European regulators could be sustained only if it were possible for mobile operators to provide termination services in isolation – i.e. without providing the subscription, handset and origination services which all mobile operators must also supply. Although such a market structure might be theoretically possible, we are not aware of any mobile operator in Europe or elsewhere that provides an 'incoming calls only' or 'outgoing calls only' service. Even if such a service was offered, operators would still have to provide a subscription service and handset to ensure that calls could be completed.

3. It is therefore not possible to analyze the provision of mobile call termination services in isolation from the provision of the other mobile services that are a prerequisite for the provision of the former. Put another way, mobile call termination services have no meaning unless a mobile operator has first invested in the acquisition of a customer to whom they can in fact terminate calls. Mobile operators must therefore invest in the acquisition and retention of mobile customers in order to create a demand for mobile call termination – but the latter cannot exist independently of the former (as the narrow market definition proposed by the European regulators implies).

4. The consequences of these 'joint production' or 'interdependent' conditions are profound for the assessment of market power. At its simplest, they mean that mobile operators will fail the SNIPP because any profits derived from increases in mobile termination rates will be competed away in the acquisition and retention of customers (unless mobile operators also hold market power in relation to those activities). This is what is observed in foreign CPP markets – any purported 'surplus' associated with mobile termination rates is competed away in the form of discounts for handsets and other incentives to retain or acquire mobile customers to the network. Regulators have themselves recognized this

'waterbed effect', without admitting the inherent contradiction between this explicit interdependence and their approach to market definition and market power**.**

5. Other commentators have observed that mobile call termination, properly, understood, is simply another example of a 'two sided market' in which platforms bring together a caller and called parties (just as, for example, shopping malls bring together retailers and shoppers). On this view, mobile termination is properly understood as being a market in which mobile operators are potentially subject to constraints not only from the buyers of call termination but from the recipients of such calls (and the buyers of other mobile services). We include three additional papers that discuss 'two sided' markets in mobile. One is by Professor David Evans, one is by Professor Jerry Hausman and the final one is by Professor Mark Armstrong (who is, among other things, an economic adviser to OFCOM). This 'two sided' constraint led Mark Armstrong to memorably characterize mobile call termination as a 'competitive bottleneck', a view that has been echoed by other advisers to the European Commission such as Tomasso Valetti.[1] Economists observe that 'two-sided' markets also involve 'interdependent' pricing, in which firms try to set an optimal pricing structure to maximize consumption across the platform as a whole. This may not necessarily mean that prices on any one side of the market are 'cost-orientated' – and nor would a competitive benchmark require that they were so. Examples abound of two sided markets in which costs are largely recovered from one side of the market only – the costs of shopping malls are largely financed by the rents charged to retailers, the costs of newspapers or Yellow Pages being largely met by advertisers rather than readers. There is not a similar debate between regulators and industry in these markets provided there is effective competition between platforms. These commentators argue that mobile termination is an example of a two-sided platform and that to presuppose conditions of cost-orientation in such circumstances is misguided and inappropriate. There is no case for *ex ante* regulation simply because a two sided markets produces pricing structures which are not cost-orientated and nor does the fact that they do so constitute evidence of market power.

6. European regulators have, to date, been reluctant to accept the foregoing 'two sided market' analysis. This is because the regulation of mobile termination rates in Europe is contingent upon a finding of 'market power' and, under the new EU regulatory framework, it would not generally be possible for them to find 'market power' in mobile markets consisting of three or four firms, all of whom compete vigorously for subscribers.

The fact that European regulators have persisted with their narrow view of market definition and market power, despite what Vodafone considers to be the strength of the economic analysis to the contrary, is evidence more of the determination of European regulators to intervene in this

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[1] *See* Tommaso Valletti, *Obligations that can be imposed on operators with significant market power under the new regulatory framework for electronic communications : Access Services to Public Mobile Networks*, Imperial College London (September 2003) *available at* http://europa.eu.int/information_society/topics/ecomm/doc/ useful_information/library/studies_ext_consult/economic_expert_group/mobile%20_valletti_final.pdf#search='Tommaso%20Valletti%20obligations%20imposed'.

area than of the merits of their decisions. In any event, these issues remain controversial (and under appeal in some markets in Europe). They do not relieve the FCC of the need to come to its own view in determining whether there is any rationale for regulatory intervention in the prices charged by foreign mobile operators, and in determining precisely what that rationale might be.